Securing Capital for An Established Enterprise

By
Louis F. Musil

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FOR

An Established Enterprise

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LOUIS F. MUSIL, E. E.

Treasurer, Cities Service Company. Associate Member of the Firm of Henry L. Doherty & Co.

In Collaboration with

B. N. Freeman, Manager; John M. McMillan, Assistant Manager; W. B. Jackson, Assistant Manager; and F. W. LePorin, Sales Manager, Bond Department, Henry L. Doherty & Co.

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1. *Developing Financial Skill*
2. *Forces Which Make Prices*
3. *Manipulation and Market Leadership*
4. *Handling a Brokerage Account*
5. *Market Information*
6. *The Essential Features of Securities*
7. *The Value of a Railroad Security*
8. *Industrial Securities*
9. *Oil Securities*
10. *Mining Securities*
11. *Investment Securities*
12. *Business Cycles*
13. *Measuring and Forecasting General Business Conditions*
14. *The Technical Position of the Market*
15. *Money and Credit*
16. *Business Profits*
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19. *Internal Financial Management*
20. *Search for Bargains*

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CHAPTER I

ESSENTIALS IN THE FINANCING PROBLEM

"There is no idea, standard, method nor theory that can be claimed best as long as the possibility exists of a better one. Let us work out these better things, and be willing to recognize them." — HENRY L. DOHERTY,
Senior Partner, Henry L. Doherty & Co.

General Factors

The raising of capital for a going concern depends upon many factors. It depends on the nature of the concern, that is, the nature of its business. Is it an industrial enterprise, a railroad, a public utility? It depends on the general conditions surrounding the group of industries of its own kind; how they have financed in the past; have they lived up to the expectations of the public which absorbed their securities? It depends on the general economic conditions from time to time. During times of prosperity financing problems are different than during periods of depression or the periods following either.

These periods of general conditions react differently on various classes of business, each of which must take into account therefore not only the general conditions, but its own resulting conditions in determining the method, the time and the measure of its financing programme. Relative commodity prices, rates of exchange, labor scales, interest rates, all interdependent but resulting from the economic laws of supply and demand, determine the purchasing power of money which must be met on its terms at all times. Securities are no different than anything else which money buys, and they must meet the competition of other securities and other classes of investment, or find themselves on the bargain counter, at an unfavorable discount which has detrimental results to the issuing companies. Hence,

the importance of considering not only yesterday and today, but tomorrow and thereafter in framing the policy of finance; the kinds of securities and their volume; their rates of interest; their maturity; in fact, all the terms which are going to be a measure of their relative standing and acceptability with all other securities issued or to be issued during their lifetime. It will bear repeating that the future possibility of any company's financing will be very materially affected by the permanency and continued relative standing of the securities issued by it at any time.

Company Policy

Aside from the general factors, a company's financing possibilities depend in a large measure on itself. What is its policy in the matter of publicity? Is it one of frankness and enlightenment to its stockholders and the public who may, if they will, become security holders? What policy does the company pursue toward the public which consumes its product; toward the banker who can recommend it and its methods? What sort of dividend policy does the company have, well defined, consistent distributions of earnings warranted by the earning power over a period of years or spasmodic distributions fluctuating with the earnings during short periods? The determination of this factor should justify consideration of the company's equity security as an investment and accordingly may strengthen all other senior issues of the company.

The proportionate amount of surplus reinvested in the business of the company is also significant to all security holders. The property in which it is reinvested is an added protection to all classes of securities. The earning power of the reinvestment is a further factor of protection, the reinvestment of which again further fortifies the financial structure. So the benefits are compounding and cumulative as is the accumulation of the dollar, the interest on which is allowed to continue working. This factor of reinvested surplus becomes more important with the increasing regulation of business and limitation of earning power. The company with a larger percentage of its earning

property created from surplus on which no fixed charges must be paid has the better assurance of maintaining its earning power and of being able to continue dividend distributions which are an important factor in the market prices of its securities, and therefore can expect these securities to have more stable markets and be more satisfactory to their holders.

Markets Afforded Buyers and Sellers

What is the company's policy toward the markets of the securities it has outstanding? Marketability is an important factor in the relative value of investments. A company's financial programme should provide a cash reserve for the insurance of such marketability, and its financing should make such a reserve possible and advisable. In the cycles of prosperity and depression come times when there is no buying power for securities that some desire to, or must, sell at whatever prices are most advantageous — perhaps at prices which would realize more profit for the company than the investment of the same amount of funds in the expansion of its regular business. Granting the economic soundness of the security at the price it is offered, the obligation of the company to the security holder who is forced to sell should be given some consideration by the issuing company. Likewise, there should be no objection to the security holder who merely desires to sell, doing so on terms advantageous to the other security holders who remain such because of their satisfaction in the company and the policies pursued by its management.

These policy matters indicate in brief review the various factors which must be considered by the management of any concern framing a financial programme, especially a concern whose requirements are more or less continuous because of the natural expansion of the business.

Which Factors are Essential?

Chapters which follow will show with some concreteness and detail how the factors which have been specified operate in

practice. We shall describe in various places the methods employed by our own company, not through any desire to emphasize ourselves but because one describes best the plans and methods he knows most about and deals with at first hand in his daily work; and also because, on account of the nature of their business, public utility companies have in certain respects worked out ideas somewhat advanced, and effective. Needless to say, in describing some of these ideas we shall keep the needs of the average corporation official in mind, not restricting our discussion to public utility financing but presenting plans and methods useful in securing funds for various types of an established enterprise.

What will be said, however, aims to render clearer and more definitely workable in practice certain essentials which, for the sake of emphasis, are stated here at the outset. The possibility of raising capital for a going concern depends on the *organization* which makes use of the capital raised and demonstrates to the public that it has in force policies relatively advantageous to the people supplying that capital; on the carrying out of those policies which insure the safety of such capital; and on a continued interest in the supply of capital which results in the issuing of securities giving fair consideration to the present holders of all securities, as well as the new issue and its buyers.

CHAPTER II

ESTIMATING THE CAPITAL REQUIREMENTS

The Corporation's Financing Problem

What is the financing problem like, as the executives of a large corporation face it at headquarters?

Operating men in charge of the company's various plants, located perhaps in scores of cities throughout the country, produce and distribute the corporation's commodities or services. These men are under pressure all the time; customers want lower rates, or at least do not look with any particular favor upon higher rates, and they are more or less insistent upon better service. Wage earners and others on the operating staff urge their claims with respect to wages, hours, working conditions and advancement. And headquarters, the operating men know, wants each property to utilize as effectively as is possible in practice all its possibilities for profit, and to exhibit satisfactory statements of earnings.

Under these circumstances, plant managers become more or less alert in looking over their respective properties, with an eye to the improvement of conditions in general and of earnings in particular. Additions to plant, installation of new machinery and processes, advertising campaigns, revised wage scales, etc., represent a few of the exceedingly numerous concrete plans drawn up by these operating men, very commonly in cooperation with headquarters. What results in general is this: Headquarters receives request after request for funds, accompanied by a more or less definite assurance that earnings per annum on this new money will be thus and so.

Headquarters, too, not to be outdone by operating men, has various new projects under consideration, all of which, like those of the plant manager, call for capital and promise (but never *guarantee*) what is termed in general satisfactory profits.

Two Important Considerations

These conditions represent growth; should they not exist the organization is in a state of dry rot, to say the least, and when they do exist, persistently and with strength, progress, accompanied by improved earnings and eventually larger rewards for stockholders, normally take place.

Well-managed corporations grow and because of this continued progress it naturally follows that the organization is still being organized. These executives, in charge of properties that are generally acknowledged to be well managed, face opportunities to improve practically every phase of their business. This state of affairs should, and in practice it does, stimulate the ambition of those throughout the organization. Hard and fast limits to the possible accomplishment of a capable man do not exist if he recognizes the fact that a demonstration of executive ability is one sure requisite that will accelerate his progress to higher levels of prestige.

While all this doubtless is encouraging with respect to the future of the company and of its individual executives, headquarters recognizes this to be the matter-of-fact situation: *New money* is called for; and if supplied, executives will spend it upon projects which they *estimate* will return satisfactory earnings. Good management demands under these circumstances the raising of two searching questions:

New Money Wanted: How much will be required and when?

Executives' Estimates: Are these estimates of our executives accurate, or seriously faulty; in short, will the profits expected actually accrue?

How deal with these questions? We believe that an effective method exists, and that the description of it which follows will indicate its wide applicability, and usefulness, in corporate financing.

The Budget System

It is a generally accepted fact that the real value in a piece of work well done comes from its careful planning rather than

the physical execution of the plan. The budget system is nothing more nor less than the application of this elementary fact to every phase of a business. Its accumulation of the plans relating to the smaller parts of the business gives the executive a blue print in dollars of the result he may expect and it also furnishes convenient means of comparing in detail his original expectations with the final result actually achieved.

The results after all are measured by the cash production commensurate with satisfactory financial position at all times. Any relations involving a company in possibilities of requiring or producing cash are a result of the following fundamentals:

(1) Operations creating net earnings.
(2) Construction.
(3) Purchase of materials.

For example, carrying on an addition to a plant involves the creation of accounts payable, possibly also of notes payable. The sale of electricity creates accounts receivable. In the purchase of supplies, contracts are often entered into with specific terms of payment creating liabilities, the maturities of which have a distinct bearing on the future position of the company. We might enumerate many other smaller relationships resulting from the fundamental activities mentioned above. It is the cash estimate and comparisons which must carefully follow up all these relationships and present the cash possibilities of the company. The fundamentals themselves, however, are so important in the creation of these relationships that they require a detailed analysis and a follow-up system if we are to understand the reason for their important effect on what we are striving for — financial position and cash production.

Variations from Estimates

The use of the system by the executive is dependent on his ability to read from the results which it presents, the degree of success with which the various plans and policies have been carried out by those in charge. For the executive completely to understand and give due credit for the results as disclosed,

it is necessary that the system show not only the results of policies already outlined but it must also provide a means for indicating the effect upon the final result of any changes in the original plan if such changes are considered from time to time. The property makes its estimate on a certain schedule of gas or electric rates, and any change in those rates must necessarily affect the results. Changes in freight rates, changes in fuel prices, changes in wage scales, all have vital bearing on the possibility of the company. Furthermore, it is impossible for the central office executive to bear in mind the different conditions pertaining to these matters of many localities. Consequently he is dependent on advice concerning changes that do take place and the effect which such changes must have on the possibilities of the company.

If the results of policies outlined are actually going to be different than originally expected, then such changes in the final results must also be disclosed as far in advance as possible. The installation of a plant might justify the expectation of fuel economies. If these economies are not going to be realized over a portion of the period or the entire period for which they were predicted, certainly the expectations are not going to be achieved and how can the executive change his original opinion unless advised? The policy of a company might be indicated by the estimate as showing the liquidation of indebtedness within the period covered by the estimate. It might well be necessary or desirable to change the policy regarding this liquidation. Estimates made might consider a certain policy regarding the expansion of the company's business, which policy might well be altered because of changes in general conditions. It is only when all such changes are scheduled, and the expected effects of a revision of policy are understood, that the executive has satisfactory assurance that the individual carrying out the plans also understands.

Why the Budget is Essential

In the evolution of the budget system, these specific needs have always been kept in view. It is in recognition of the fact

that an estimate cannot cover all matters, nor cover with absolute correctness those which it does embody, that the system provides for the keeping of a log of the changes in the fundamental factors showing the effect those changes will have on the originally estimated performance. The total of these log items, when taken in conjunction with the original estimate of the expected performance, will represent the up-to-date expected performance at any time. Furthermore, the advice of the entries made on this log to the executive of the property, and to a central office, gives to all concerned the same up-to-date expectation. Assuming the average correctness of these expectations, the entire organization is then in the best possible position to meet the requirements, financial or otherwise, and to choose the time when those requirements can be met to the best advantage.

Is it not well for all of us to ask ourselves the question, how could these requirements of the organization be known without some such system, and if not known, how can they be provided for to the best advantage? We might well ask a further question as individuals of responsibility: Why should we not be expected to be able to disclose to all concerned, the position which we anticipate our activities to present, and why should we not assume the higher executives will expect such estimates as we make from time to time to approximate at least the best possible result?

A Common Language

Ability frequently goes unrecognized because the individual is unable to express his ideas in an understandable language. The larger the organization, the more necessary it becomes to have a language in common to all and in daily use. A budget system, while it may not be the best medium, at least accomplishes this purpose. In addition to providing a common medium of expression, the system presents the expectations, the anticipated changes, and the actual results of the business in such form that the executive knows by inspection just what someone else is trying to tell him, and he is therefore enabled

promptly to indicate to that individual that he understands. The busy executive has not the time to make a detailed analysis of the many things which come to him for consideration. Matters for his decision must be analyzed before they are submitted to him.

The budget system should exhibit in readily comprehensible form all of the fundamental factors which an executive must take into account when he is asked to give his approval to policies proposed to be put into effect, or which factors he must take into account to enable him understandingly to stamp results as satisfactory or otherwise. Furthermore, the expression by the executive of his opinion as to the results is essential if corrections are to be applied where necessary and the desired incentive given because of his recognition where deserving. To accomplish the fullest benefits we should be equally as prompt to extend praise for work well done as to complain of the contrary. Sometimes this is forgotten in the rush of business and real harm is done both to the man and the business by leading an efficient individual to fear that nobody cares or that perhaps he has not done the job satisfactorily after all.

Control *vs.* Knowledge of Control

There is a distinctive difference between Control and Knowledge of Control. It is often the former which is desired by the individual striving for executive authority, but the latter which is wanted by the true executive. With the Knowledge of Control it is the duty of the executive to pass the actual control to those responsible for doing the work which is going to produce the results. On the other hand, without this Knowledge of Control, safe and proper judgment cannot be passed in approving for procedure the various parts of the estimated programme, nor in considering new needs becoming apparent above the horizon under the constantly changing conditions confronting any business. Unless we all know what factors have been considered and the status of those factors, we cannot intelligently pass judgment. And on what is our knowledge of these things dependent if not on the means which the other man has to tell his

story and our means to conclude that he has or has not told the whole story correctly? In other words, in order to let us know, the man responsible must first know himself what result to expect and if he does not know, or cannot show that he knows, we would better reach the conclusion that it is our duty to spend some time on the man and not on his concrete problem.

Executive Responsibilities

The responsibility of the executive can be readily divided into two classes; one of these, the duty to supply whatever knowledge or time he can to help any other individual in the solution of a specific problem, needs little mention in an organization whose spirit of co-operation is well developed. The other and more important responsibility of the executive lies in the solution of the psychological problem of creating between his subordinates and himself, and in turn between himself and his subordinates, a mutual consciousness of knowledge and understanding.

Many questions on which we spend much time will be answered by the ingenuity and initiative of the individual himself through the recognition of these simple principles:

(1) Do we know that he knows?
(2) Does he know that we know?

We believe these are fundamentals not only of psychology but of executive management. If the executive makes it clear to the man down the line that the latter has not shown he knows, this man, if capable, will devise his own methods of keeping track of his progress and will not only be able to tell the executive but will make sure that what he does tell will measure up to their mutual expectations.

The ability to forecast satisfactory expectation, to foresee the effect of further factors affecting the forecast as originally made, and to achieve results in accordance with predictions, all represent control. This control is not only essential in securing the best possible results, but the consciousness that the executive has the knowledge of this control assures the maximum of

satisfaction and happiness to the individuals striving for such results as well as the further efficient development of the organization.

Financial Requirements

The problem of new money wanted and earnings which justify it, is as we have tried to point out, a very matter-of-fact human affair: An executive is trying to make good, both for his own interests and that of the company; and the concrete plans drawn up for this purpose call for new money. What means will best stimulate him in these praiseworthy activities; and provide at the same time the most satisfactory measure of his success and check against undue losses through wrong estimates — this represents the real problem faced at headquarters.

How Meet the Requirements

While the company's financial requirements are being estimated in the way described, members of the organization are likewise working out plans and methods designed to secure these funds. Due to the fact that the requirements embrace an extremely wide variety of objects — ranging perhaps from minor betterments in some small plant which can readily be provided for out of earnings to plans for the opening up of an entire new industry which marks a new era in the company's expansion — various methods rather than one, will be employed in the financing which ensues.

The larger projects in the company's program, those which call for the most highly co-ordinated methods, will be described first, because they constitute Wall Street's best advertised and, in many respects, most characteristic operations. These syndicate flotations form the subject of the two chapters which follow.

CHAPTER III

SYNDICATE OPERATIONS

Underwriting

The new money desired by a corporation and which it now proposes to raise in large amount, let us say, has to be secured in one way or another from capitalists. These capitalists may, or may not, be wealthy since we use the term here merely to signify persons in possession of funds, who are willing to exchange these funds for securities. Shall the corporation approach these persons directly or through some middle man?

The locating of these capitalists and the selling of securities to them is a somewhat intricate matter, in which the average corporation official has had little specialized experience. Were this official to attempt the sale of his company's securities in large volume, there would be little definite assurance of success. The plans for the carrying out of which the securities were issued could be pushed only haltingly; failure to dispose of the issue within the time limits determined in advance by the operating executives or to dispose of perhaps not more than one-half the amount necessary, might force the entire project to be abandoned. These difficulties, and others which could be cited, are not overdrawn.

The costs and the risks involved cause most corporations when it comes to flotations of any importance to call in the services of investment bankers, rather than rely upon their own organization's selling efforts. These investment bankers and brokers are specialists; they know the special knacks of the trade, the fashions which come and go in securities; they have well established credit relations, trained sales forces, and, most important of all, a clientele accustomed to act upon their advices when investing. Being specialists, skilled in the business, and engaged in it continually, they can, better than the average

corporation official, cope with the problems met in flotation. These bankers and brokers underwrite or guarantee the sale of securities.

Early Syndicate Operations

The underwriting of large financial undertakings is not a recent development. History records examples of underwritings by potentates and princes centuries ago. These underwritings were not then called by that name, but the same results were accomplished, the "patron" of the offering lending his prestige — and occasionally the pressure of his power — to making such offerings a success. The expenses of wars of conquest were frequently so underwritten.

Early in the eighteenth century, syndicates for the financial underwriting of new projects came into being. These syndicates were the outgrowth of the natural drift toward the development of the hitherto untouched natural resource treasures of the Americas, Africa and the Far East.

The members of such underwriting syndicates, in the fashion of the days of royal prerogative, lent their names and prestige, but rarely risked their means in such personal underwritings, being held free of personal liability in the event of failure of the syndicate to raise the necessary funds.

English syndicates, headed by Earls and Baronets, were promptly followed in such plans of finance by Spanish groups headed by Grandees and Marquises — these latter groups functioning with indifferent success — and under royal warrant were given valuable grants in the overseas colonies and countries which the new spirit of adventure and expansion had brought to the attention of the financiers of Europe.

Dutch, Portugese and French companies were likewise formed — the more patient and methodical Northern Europeans, however, being more successful than the Latins in these operations.

The lure of gain and the ever-human trait of expecting the far-off investment to yield returns which the one nearby would not, made these syndicates extremely popular.

Unfortunately, they oftentimes were run for the personal profit of unscrupulous adventurers, but many of them laid the foundation of large fortunes which through wise handling and careful reinvestment have grown to mammoth proportions in the past two centuries.

Bankers as Syndicate Managers

The development of commerce and the increase of wealth which resulted from it enabled certain persons to specialize in the business of safe-keeping and lending money. These bankers in due time, as could naturally be expected, undertook the work of organizing syndicates. For the most part they held their respective interests as bank investments, although a part thereof were apportioned among the clients of such banking houses. Such investments yielded comparatively smaller profits than were usual in these operations, largely on account of the conservatism which followed the passing of these underwritings into bankers' hands.

Continental bankers had, for several generations prior to the World War, taken a still more radical position in the promotion of industry. After a careful analysis of the situation by banking experts, coupled with a survey of the possibilities by technical and merchandising experts, many new infant industries were taken up and developed by such bankers, often by a syndicate composed of several.

These syndicates did not confine themselves to natural resources alone, but encouraged, through financial support and co-operation through their numerous affiliations, manufacture and distribution as well.

Through the modernizing of financial methods, formation of underwriting syndicates for the financing of all kinds of industries during the latter part of the last century, and the methods used and channels through which underwritings were placed, have gradually changed and are still changing.

Present-Day Methods

Banks and bankers now form underlying bankers' syndicates

for the specific purpose of offering to dealers and brokers in securities issues which they have carefully investigated and which through expert knowledge they have surrounded with all essential or expedient safeguards. For their fee in assuming the obligation to take up so much, if any, of the issue which might not be underwritten by the dealers and brokers, as well as for their labor in preparing the issue, the underlying bankers' syndicate receives a small commission, usually called an "originating fee." One or more of their number are usually designated as syndicate managers.

Frequently the bankers forming such underlying syndicates reserve the right themselves to participate with the brokers and dealers forming the underwriting syndicate.

Such underwriting may be made in either of two forms:

(*a*) A definite commitment for a fixed amount of bonds or number of shares of the security syndicated.

(*b*) An underwriting for a percentage of the total offering.

Commitments

The dealer or broker "committing" for say fifty thousand dollars of bonds of an issue buys, either for immediate delivery or for future delivery within a fixed period, fifty thousand dollars of bonds at a fixed price — with interest of course in the case of bonds to the day or days when such bonds are "taken down," as the phrase goes, and when he has thus closed his commitment, his liability ceases.

At times, instead of the price being fixed, the market price controls the "take down" cost to the dealer. This necessarily need not be constant, but may vary from day to day. In this latter event, it is usual for the dealer to receive, regardless of advance or decline in the market price, the same fixed profit per unit of securities sold, whether share of stock or $1,000 principal amount of bonds.

Underwritings

When a dealer or broker subscribes to an underwriting, his primal function is to stand ready at the syndicate's close to

"take up" any part of his allotment in the underwriting not disposed of by others.

It frequently happens, in fact, it is a general practice, for underwriting dealers also to sell for syndicate account the securities underwritten. However, this is optional with them. Bankers organizing syndicates do not desire non-selling dealers as underwriters in issues which are readily marketable and such dealers are called "riders," who, knowing they take no chances in assuming the obligation of underwriting, do so for the purpose of securing a share of the underwriting profits. "Riders" are universally frowned upon and reputable houses cull them out as unworthy of offering participation.

Arrangements Concerning Sales

Underwriting agreements may provide either that the sales for syndicate account made by individual dealers reduce the individual liability of the underwriter — these being called limited liability syndicates — or such sales may be made for syndicate account, reducing all participants' liability pro rata.

In the event that the syndicate managers are given the power, through the underwriting agreement, to repurchase from the market any part of the offering in order to create and stabilize a buying and selling market, the profit of the syndicate would naturally be somewhat reduced. While the "Selling commission" is much smaller in this instance, individual dealers are not compelled to repurchase and redistribute securities originally sold by them coming on the market, which provision is customary in limited liability syndicates.

Profits to participants in a limited liability syndicate are usually arranged as follows:

Between twenty-five and forty per cent of the total gross syndicate profits is deducted in the form of selling commissions at the time dealers "take down" securities for syndicate account. The dealer thus receives only part of his profit at billing, the balance being paid to him at the time of syndicate settlement. This settlement takes place when the issue has been sold or when the period of operation originally decided upon terminates.

A dealer may "oversell" his allotment in an underwriting plan for which the usual selling commission is allowed and at syndicate settlement, an additional "oversales" commission is paid. This "oversales" commission is generally charged as a syndicate expense, although the recent and more equitable practice is to charge this against the profit of those participants selling only part, or perhaps none of their allotments, this charge being made as the cost of selling such of their securities as they may not have taken down and paid for.

How Syndicate Profits are Determined

In determining the profit finally to syndicate members, let us take a hypothetical case. Say an offering were made of \$10,000,000 Atlantic Electric 7% Debentures to be sold to investors at par and interest, and the underwriters' syndicate receives the debentures at $98\frac{3}{4}$, with selling commission of $\frac{1}{2}$ point, and an additional oversale commission of $\frac{1}{2}$ point. Needless to say, these particular figures are taken only for purposes of illustration, and the conclusion should not be drawn that syndicates always, or even usually, conduct their operations at these prices. Much depends in a given case upon the credit standing of the company, the issue of which is floated, the type of security offered, conditions of the money market, etc., in short, the various factors cited in Chapter I.

$1\frac{1}{4}$ points profit on \$10,000,000. (From this are deducted expenses incurred by the syndicate managers in managing the syndicate)		\$125,000.00
Telephone and telegraphic charges (for wiring the offering to dealers and for confirming sales made by them)	\$3,750.50	
Printing and stationery (for printing descriptive circulars of the offering for information of security buyers)	2,107.50	
Advertising (in daily papers as well as in other publications and in standard financial journals as matter of permanent record)	8,111.00	
Postage, registration and insurance (in mailing circulars and securities as well as registering and insuring the latter)	2,290.90	
Carried forward	\$16,259.90	\$125,000.00

Brought forward	$16,259.90	$125,000.00
Interest. (The syndicate charges interest to date of payment but as payment is frequently elsewhere than at New York, there is a loss in interest while funds are in transit)	2,330.50	
Exchange and collection. (Exchange on checks drawn on out of town banks and the banks' collection charges)	281.40	
Labor and expenses. (The syndicate managers usually charge only extra expenses for additional labor and expenses incident to holding their staffs after hours)	906.50	
Legal expenses. (For examination of the Indenture, the actions authorizing the issue by stockholders and directors, etc.)	1,500.00	
Selling commission. (This is ½ point which is deducted at time bonds were "taken down" by the dealers)	50,000.00	
		71,278.30
Leaving balance of		$53,721.70

Or an added profit on each $1,000 participation of $5.37.

It is obvious that where an even $10,000,000 are sold, the "oversales" of the brokers overselling their allotments will exactly equal the "undersales" of those having allotments but not selling either part or all of such allotments.

As an example suppose a broker were allotted a syndicate participation of $100,000 in such syndicate and sold $125,000 bonds, his profits would be as follows:

One-half point on $125,000	$625.00
One-half point on oversale $25,000	125.00
Syndicate profit on $100,000 at $5.37	537.22
	$1,287.22

Or a total profit per bond to such dealer of $10.29 per bond sold.

Now, on the other hand, suppose such broker had sold for syndicate account only $75,000 bonds, his profit then would be:

One-half point on $75,000	$375.00	
Syndicate profit on $100,000 at $5.37	537.22	
		$912.22
Less undersale charge of one-half point on $25,000		125.00
		$787.22

Or a total profit per bond to such dealer of $10.49 per bond sold.

From comparison of the above profit statements it may be seen that in the first case the dealer would have profited by taking a larger participation, which of course is so, but his liability would have been larger. On the other hand in the second case had the syndicate been unsuccessful the dealer would have been under the obligation of taking up $25,000 of bonds on which there would be no market for profitable distribution.

Some syndicates are formed providing for a definite underwriting on a fixed amount of securities with an option on an additional amount of the same issue. In this event, the participants are usually relieved of all liability — in the case of a limited liability syndicate — when the amount originally underwritten is sold.

No new allotments are made on the optioned amounts and when the entire amount of both the underwritten and optioned securities are sold, the syndicate profits are pro rated on the entire offering in the ratio that each participant's allotment bears to the original amount underwritten.

For example, suppose a dealer had a participation of $100,000 in an underwriting syndicate of $10,000,000 bonds and such syndicate had an option on an additional $5,000,000 at the same price and on the same terms. When his syndicate profit is computed, it is on the basis of 1% of the entire syndicate profit — subject, of course, to the oversale and undersale factors.

Such options are frequently given to an underwriting syndicate at an advanced price over that at which the underwritten securities are sold. In this case, the syndicate participants' profit statement is further complicated through the necessity of computing the oversales at two prices, the original underwriting price and the option price.

The Present Trend

The present trend in finance, insofar as syndicates are concerned, is towards the association of groups of brokers to investigate, underwrite and sell issues negotiated by a committee elected by such group. The advantages are numerous.

The bankers' commission is saved, the brokers through closer association work more effectively together and have a more intimate interest, both from their own viewpoint as well as that of their investors.

The personal interests of such a group of dealers are served best in obtaining for their clients the greatest possible security and the best return consistent with safety.

A Syndicate Operation Described

With this much said in general of syndicates, let us now take up for consideration a typical operation undertaken by a syndicate in the process of financing a certain growing enterprise.

CHAPTER IV

FINANCING A GROWING ENTERPRISE

The Lender's Viewpoint

The sale of a bond issue of a corporation is simply an organized method of placing a loan for the company and it therefore follows very naturally that the limit of the amount of capital which can be obtained in this manner is based upon the past achievements of the business rather than what it may do in the future. The lender is generally deaf to all argument as to what the company is going to do and he confines his inquiries almost completely to the question of how much property there may already be in the situation of a demonstrated value and the amount of earnings which the corporation has already proved that it is able to produce.

The Borrower's Problem

For these reasons a rapidly growing enterprise often has to be financed in stages. The operators first invest their own money and demonstrate the success of their investment. Then it is possible to borrow from the public some conservative percentage of the capital previously invested. The operators then proceed to invest this and additional money in further expansion of the business and then they can borrow from the public again. In this second operation they may be required to pay off the first loan and replace it with a new larger first mortgage issue. On the other hand, they may have been so fortunate as to demonstrate that the enterprise is secure enough to warrant a junior obligation. It is not uncommon to see a growing enterprise go rapidly through several stages of financing by successively placing a loan only to redeem it and put out a larger one. Some times the original issue is left outstanding and the new

one is made a first mortgage on certain new property and a second on the other.

"Setting Up the Deal"

Assuming any definite state of conditions already existing, the corporation and the bankers work out the problem of how they can furnish adequate and acceptable security to the lenders with or without repayment of loans previously placed. At the same time numerous other problems have to be considered, such as the ruling rate of interest demanded by market conditions at the time, special requirements due to the character of the business, and numerous other matters. This is called "setting up the deal." Included also as part of the problems to be met under these conditions may be mentioned the state of the investment market and the all important question as to whether the business of the company and its record are well enough known to the requisite number of investors or whether, in the absence of such acquaintanceship, a satisfactory public introduction can be promptly effected.

An Example

There is no better means of illustrating all of these considerations than by recounting briefly the history of financing of the important group of petroleum and natural gas properties owned by Cities Service Company in Kansas, Oklahoma, and Texas, in what is generally known as the mid-continent field.

The First Problem

In 1916 the situation was as follows: Cities Service Company owned the stocks ahead of which there were some bonds outstanding in the hands of the public, of several important natural gas companies, particularly in Kansas and Oklahoma, whose net earnings per annum were at the rate approximately of $1,200,000. Research by geological experts conducted by the holding company, with a view of enlarging these subsidiaries, had resulted in the acquisition of large acreage of oil and gas lands, upon

which test drilling had definitely revealed the presence of important amounts of oil. These exploration and development operations were conducted under the name of a new corporation organized for the purpose partly to avoid the danger of having the expected earnings become part of the revenues of natural gas companies and thereby fall under the control of rate regulating authorities for public service. Cities Service Company, of course, advanced the funds by which these oil developments were effected.

Immediately upon proving that important amounts of oil existed on these lands the fact became apparent that large amounts of money would be required to develop the property. Oil production is very profitable but, before the revenue may be expected, an expenditure has to be made from some source in order to drill a well. In this instance, two tracts aggregating more than 20,000 acres were held under leases, the terms of which required "due diligence" in completing the drilling operations. The early developments had "brought in" production amounting to several thousand barrels of oil daily and established the fact that a great deal more would result with the drilling of additional wells; but millions of dollars were required for the latter operation.

The Market

At the time the public was not accustomed to bond issues secured solely by oil production. In other words, the most genuinely valuable intrinsic security which the company had to offer for a loan was not appreciated as such by the public. The latter gave more serious consideration to the earnings of public utility enterprises, hence it was accordingly obvious that the earnings of the natural gas properties would be helpful in setting up the loan. The problem of using the natural gas companies as security was complicated, however, by the fact that some of them already had bonds outstanding. Therefore, the new loan proposed would have to be expanded to include not only the money required for more drilling but also the payment of these underlying natural gas bonds.

The Security

In the judgment of the operators and of the investment dealers who would have to sell the proposed new bonds, the loan would be intrinsically safe on the oil properties alone but it was believed the public would demand not only the natural gas earnings as further assurance but also some additional factor of security to compensate for the fact that natural gas enterprises had not uniformly proved a success. On the contrary, there had been some painful failures along that line which were fresh in the public mind.

It was obvious that a guarantee of the proposed new bonds by Cities Service Company would remove the difficulty because the latter owned a large number of public utility companies, whose successful operation was well known to the general public. But Cities Service Company already had a note issue outstanding in the hands of the public of $7,000,000, which might interfere with the acceptability of its guarantee of the proposed new bond issue. The way out of this difficulty, therefore, was to expand still further the original figures so that the new loan might include funds sufficient to redeem and pay off Cities Service notes.

The First Problem Solved

Approximately $10,000,000 of the new issue had to be used, therefore, to pay off other obligations in order to set up the loan where the security would be sure of being acceptable by the public. The next question was how large a loan could be placed and what net amount of money could be realized for the handling of the oil well drilling. The loan was finally set up at $14,000,000 in the shape of a closed issue by a direct first mortgage upon the oil-producing properties and further secured by the deposit of the stock of the natural gas companies without any bonds ahead of the latter and with a covenant that none could ever be issued.

A third element of security was added in the form of a guarantee of principal and interest endorsed on each bond by Cities Service Company. The statements to the public showed that

the oil properties were very valuable and that the natural gas properties alone were earning more than enough to pay the interest charges on the new loan. Also the issue was guaranteed by Cities Service Company whose record of successful management of its properties was alone in the minds of many investors, sufficient assurance of the safety of the new issue. A very high rate of sinking fund payments was incorporated into the issue. The bonds issued under these conditions were promptly sold and the offering was a signal success.

The Second Problem

Meanwhile another problem came into the situation. Along with the rapid increase in the rate of oil production came the question as to whether Cities Service Company should limit its activities in the petroleum industry merely to production of oil or enter also into the refining business in order to diversify its interests. In the latter case, it would be necessary not only to build or acquire refining plants but also to make sure of transportation facilities between them and the fields, that is, pipe-line construction was part of the refinery question. It was decided that the scope of activities should be enlarged and Cities Service Company accordingly purchased a number of refineries and began the construction of pipe lines. The refineries were "going concerns" with established records of earnings and it was believed that the public would be willing to make a loan on this character of enterprise, carrying with it as it does in the public mind many of the aspects of a manufacturing operation and presumably perpetual life.

The Second Stage Reached

In 1917 the plan was determined upon of offering to the public a loan of $7,000,000 on these refining companies. In setting up this loan it was believed that the public would regard the statement of past earnings as satisfactory assurance of the future, provided, however, some assurance would be afforded that the refining companies would not have any difficulty in

obtaining a supply of crude oil which, of course, is a critical matter in refining operations. It was accordingly decided that the oil producing company which had previously been financed with such success and which was more or less widely known to possess great quantities of oil, should affix its guarantee to the new bonds of the refining company. Such a guarantee would not only assure the oil supply but would also add the good faith of the producing company to the loan. The oil company by that time had succeeded with its developments in a most satisfactory way. The public promptly accepted the loan offered so set up, and another stage of financing this important group of properties was achieved.

Growth Continues

During the course of these events, the work of research was, of course, continued and geological surveys were made in great detail over large sections of the mid-continent country where oil and natural gas might be expected to be found. These scientific studies indicated the wisdom of accumulating leases upon millions of acres of land and the character of formations in many places were so promising as to warrant a good deal of test drilling. Explorations, of course, followed these geological studies and separate corporations were formed to carry them out, the funds being supplied by Cities Service Company. For instance, certain extensive and very promising operations in Oklahoma were put into one corporation and all of the work in Texas was put into another.

These explorations greatly widened the sphere of activity of Cities Service Company in the mid-continent field and definitely assured important oil-producing properties in a number of places. As a natural result the original problem repeated itself and by 1919 the question became important as to how a new loan could be set up which would make available a considerable amount of capital for further oil drilling and other development expenditures.

The Third Problem

Clearly this group of properties in the aggregate had an intrinsic value running up to an immense sum, for the gross earnings then amounted to more than $60,000,000 per annum and the net earnings were in excess of $20,000,000. It was desired to raise approximately $15,000,000 of new money. Should the old loans be paid off and a new loan placed large enough to supply the new money and retire the other debts besides? The latter amounted to approximately $20,000,000. Would the problem of selling $35,000,000 of bonds prove unwieldly? Was not the amount of the original debts small enough in the light of the important scale of the business, so that they could be left undisturbed while the new money was raised at the same time? The consensus of opinion was that they could be, but that first of all it would be necessary to make sure that investors all over the country, represented by investment dealers and bond houses, should first be shown the extent to which the business had grown.

A Private Train

The "Doherty Special" was conceived as the means by which a new or renewed introduction of these properties to the public could be most expeditiously effected. Telegrams were sent to a representative group of investment dealers inviting them to join a party which would visit these properties by a special train and the guests were, of course, assured that their acceptances of the invitation would not obligate them in any way. The purpose of the expedition was to show the properties and no bond issue or any other security offering was presented to the guests for their consideration during the course of the journey. It was stated, however, that a plan of comprehensive financing would be submitted shortly after the guests should reach home. This arrangement made it possible for the visitors to keep their minds free of the usual questions in regard to the salability of a bond issue, namely, the interest rate, the price to investor, the particular features of the set up, etc., and enabled them to devote themselves to becoming acquainted with the property itself.

Inspecting the Properties

There were about two hundred men in the party which, within ten days after the trip had been decided upon by the company boarded the special train for a five thousand mile journey with an itinerary calling for every minute of the time of over two weeks. On reaching the headquarters of the operations at Bartlesville, Oklahoma, the party was given lectures on the petroleum business and how it is conducted, from geology to gasoline, and moving pictures especially prepared for the purpose were used to illustrate field operations. A round of the properties was then begun and at every pause a talk was given by some one of the field men, who would describe his work.

Thus the party not only saw the properties of the company, but at the same time the guests were given a liberal education in the petroleum industry so that they could appreciate what they saw. The party was taken to see the "shooting" of an oil well and was conveyed hundreds of miles in automobiles to see well-drilling operations in Kansas, Oklahoma and Texas. They were also taken through refineries, casing head plants, natural gas compressor stations, warehouses, shops, and told in each instance just how everything "worked." The company also made it a point to introduce to the party the operating managers, superintendents, and other major and minor executives so that the visitors might not overlook the fact that the property had an efficient and aggressive staff of operators. Very often these operators were called direct from the job to talk to the party and describe their work.

At the conclusion of the journey the party was assembled at a hotel just before the train began its return for the north and the east and at this meeting they were again told what they had seen and were given facts and figures as to the extent of the properties, the present state of the earnings and what the company expected to do in the future.

As a result of this inspection trip the visitors had a fuller understanding of the petroleum business and of the reasons why additional funds were needed for a prosperous enterprise, they gained, through intimate acquaintanceship, a confidence in the

stability of the business, they learned to rely upon the judgment and ability of the men they saw in charge of its work and they were in a position to tell their customers and personal friends the concrete basis for their faith in the company.

Syndicate Planned

A few weeks after the journey ended a telegram was sent to bankers, investment dealers, and brokers reading as follows:

> Empire Gas and Fuel Company purposes to issue twenty-five million dollars bond secured sinking fund convertible six per cent notes dated June fifteenth nineteen nineteen, due June fifteenth nineteen twenty-four, convertible at any time at par into a new issue eight per cent cumulative preferred stock of the Empire Gas and Fuel Company. Notes will be direct obligation of Empire Gas and Fuel Company with other companies including the Empire Refining Company joining in the note indenture, these companies together constituting substantially all the petroleum and natural gas subsidiaries of Cities Service Company operating in Kansas, Oklahoma, and Texas.
>
> Considered together these companies are producing approximately forty thousand barrels high grade crude oil daily a large part of which is transported in their own pipe lines to their refineries and in addition are transporting and marketing an average of over one hundred million cubic feet of natural gas daily. Empire Gas and Fuel Company owns leaseholds of more than twenty-two thousand acres of fully proved partly developed oil land in Butler County, Kansas, and in addition these companies together own oil and natural gas leaseholds on over three million acres in various other Mid-Continent fields including two hundred and fifty thousand acres in the Ranger field. Up to date in addition to the value of the leaseholds of these companies they have invested in physical construction more than seventy million dollars.
>
> Note Indenture provides sinking fund for retirement each month beginning October first nineteen nineteen of one per cent of the principal amount of notes outstanding. Notes are secured by deposit as collateral of fifty million dollars principal amount Empire Gas and Fuel Company six per cent sinking fund gold bonds due nineteen thirty-nine secured by a first and refunding and collateral trust mortgage being part of an issue of one hundred and fifty million dollars of which approximately eighteen million five hundred thousand dollars are reserved to retire underlying liens and approximately fifty-one million five hundred thousand dollars may only become outstanding under provisions of note indenture at rate of fifty dollars in bonds for each one hundred dollars additional investments in capital account.
>
> Total funded debt outstanding of companies joining in the note indenture including present issue will only be approximately twice the amount of net

earnings from operation for the past twelve months. Gross earnings of companies joining in note indenture for twelve months ended February twenty-eight, nineteen nineteen were approximately sixty-five million dollars while net earnings applicable to payment of interest on notes were in excess of twenty-one million dollars or more than twelve times annual interest charges on notes now purposed to be issued.

We are forming syndicate in which we shall participate for sale and distribution of fifteen million dollars principal amount of these notes with option to syndicate on an additional ten million dollars principal amount on same terms. If when and as issued to us syndicate will receive notes at ninety-three and one-half. Selling price to investors will be ninety-seven and one-half. Selling commission one and one-half points to syndicate participants with an additional selling commission of one and one-half points on all sales in excess amount each members participation which additional commission will be charged to account those members selling less than amount their participation. Members may allow dealers one point and institutions and banks one-half point. Syndicate will expire August first nineteen nineteen, unless sooner terminated by us. We reserve right to extend syndicate not exceeding total of ninety days from August first. Liability of each member limited to amount of respective participation. Sales credited against individual liability. Participating dealers will be furnished circulars on advice of number desired and imprint.

If you desire to participate in this syndicate kindly advise us promptly by wire to what extent. We will then insofar as possible endeavor to meet your wishes and will wire allotment. We reserve right to reject any application also to allot less amount applied for and to close syndicate list without notice. Participations will be received up to noon Tuesday, June tenth, unless sooner terminated by us. Syndicate managers will make no charge for their services as they are being otherwise compensated. Temporary certificates will be issued as of date June fifteenth and sales if when and as issued may begin at once.

HENRY L. DOHERTY & COMPANY,
Syndicate Managers.

The above message drew a most cordial response. Conditions in the market for investment securities were exactly suited to the character of the issue and its setup met with practically unanimous approval. Almost three hundred different firms asked for and received allotments of participation in the syndicate. The offering was favorably received by the public. Sales began to be recorded immediately in large volume in nearly every important market in the country; and thus another stage

in financing the growth of this enterprise had been passed with success.

Methods of Selling Securities

What has been said illustrates the problem of refinancing as the executives of a growing enterprise encounters it, and the methods of its solution with particular reference to comparatively important flotations in which syndicate operations are involved. When these methods are employed, a corporation disposes of its securities to investment banking or brokerage houses who, as middlemen, underwrite the issue and in turn dispose of it to investors. These banking and brokerage houses may market their securities over the counter or through listing on some exchange, or both. Distribution to the public is aimed at, whatever methods are employed.

The company, however, may act as its own distributor, selling its securities direct to investors. The methods which experience has shown most satisfactory will next be described, since at times they may well constitute the chief means used in a particular company's financing.

CHAPTER V

SELLING SECURITIES DIRECT

Consumers as Security Purchasers

When a company undertakes to sell its securities direct, the consumers of its product, or customers, suggest themselves as possible purchasers. This is particularly true among the gas and electric companies, many of which are now fully alive to the value of security holders among the customers of their service.

Our organization, as an illustration of this practice, has on more than one occasion put aside an opportunity to sell securities involving very considerable sums to well-to-do investors, able and willing to pay promptly in cash, choosing instead the more tedious process of selling the issue in question, a few shares at a time, on extended terms of payment to a large number of people of moderate means. Their aggregate good-will was deemed to be a consideration of equal importance to that of raising the necessary capital for the program of physical improvements.

There is no thesis nor text book nor any other means of explaining corporate business to the uninitiated or thoughtless which is in any way comparable with the lessons which will reveal themselves to the man who is a stockholder. The reason is quite simple. None of the questions regarding the capitalization of an expected future, or the justice of earnings of large amounts in comparison to the bare dollars invested in physical property, ever arise in the mind of a man respecting his personal business. His coldness of heart in these matters is manifest only in respect to the other man's business, particularly when these principles operate through a corporation owned by absentees.

We have had a considerable experience in designing methods to encourage the distribution of securities to people of moderate means and have for years included in our selling plans a scheme of compensation to investment dealers which enables them profitably to seek small as well as large investors in our securities. Lately, we have more intensified our efforts to increase the number of stockholders in our companies in the communities in which we do business.

Denver Company's Successful Advertising

An interesting piece of successful advertising which was employed in one of our campaigns to persuade public utility customers to become security holders in the business, was the following letter on the stationery of The Denver Gas and Electric Light Company, which was distributed in sealed and addressed envelopes to every name on the books:

A PERSONAL MESSAGE TO EVERY CUSTOMER OF OUR SERVICE

You are invited to become financially interested in this Company.

The gas and electric business is remarkably stable. The earnings of this Company are but little diminished by business depressions, nor much inflated in periods of unusual prosperity. It is a business that keeps a very even course throughout all conditions. It therefore fulfills exactly the requirements for permanent and safe investment.

This Company is now bringing out an issue of $1,500,000 of Preferred Stock, which will be sold to retire certain of the Company's Bonds, and to provide money required for gas and electric improvements necessitated by the ever-growing City of Denver.

Instead of allowing the sale of all this stock to Eastern bankers (who have offered to buy the entire issue) I have decided to take a hand in the business myself to see that the Company's customers may, if they want to, become partners in the business.

The stock is a well protected, safe and sane investment, which will pay you over 6% per year in monthly dividends and, in my judgment, it will never give you worry over the safety of your money.

I am recommending it to all my friends.

Yours very truly,

WM. J. BARKER,
Vice-President and Gen'l Manager.

The letter was also run in the advertising columns of the newspapers in generous space alongside of an orthodox financial advertisement setting forth the particulars of the new offering.

Sales Methods Employed

This letter brought genuine prospective investors into the office in such numbers that for about three weeks it was not necessary to seek any by personal solicitation. On one day the purchasers who called in response to this advertisement paid nearly $35,000 in gold coin in making their settlements!

Following the activities produced by this means, a definite plan of personal solicitation was pursued which extended to approximately 5,000 interviews. New stockholders of the company were acquired in that city as a result of this campaign to the extent of about 500, of which more than half had never before owned securities in any corporation.

It is scarcely necessary to analyze the reasons for the pulling power of the foregoing "copy" except to remark upon how different it is from the customary form of financial advertisement and to remind the reader that of course it alone would not have closed many sales without cordial and effective personal receptions at the office to visitors whose interest was stimulated by the letter.

Sale of Stock to Employees

Employees, like customers, have not primarily been considered in the relation of security purchasers; with them, productivity, loyalty, contentment, etc., represent very properly the chief considerations. Opening to employees the opportunity to share in the enterprise as stockholders, however, has oftentimes proved effective in cultivating among them the desirable traits just specified. And if, in addition, money is raised which the corporation well can use, are not executives justified in looking upon the sale of stock to employees as a matter of some little importance? The increasing popularity of this plan during recent years appears to answer this question in the affirmative.

Special Considerations

There are certain special considerations which merit attention should a company seek to have employees subscribe to stock. Special terms, for one thing, are customary; this means that employees secure their stock a few points under the prevailing market price and that payments on the installment plan are usually provided for. These installment payments, incidentally, encourage thrift. A par value of less than $100 is in some respects desirable. And should the company's common stock be speculative it likely will be preferable to restrict employee purchasers primarily to bonds or preferred stock; employees are not skilled in the ways of the stock market and declines are rather awkward at times to explain to them.

The true import of these, and similar, considerations lies in the fact that selling stock to employees ought to be regarded as a building of organization good-will, in addition to its service in securing funds.

Cultivating the Good-Will of Stockholders

Those who have once purchased the securities of the corporation, either through some outside source or from the company direct, exhibited a specific interest in so doing. Granted that this interest on the stockholder's part centered primarily in his dividend check, should the company indicate by its conduct that it has no interest in him save in mailing this check? Were this policy to prevail, what might be made valuable assets would be neglected, as corporations are coming to recognize.

The policy of publicity, of stating frankly what the company has done, its present status and prospective developments, represents one essential method of cultivating the stockholder. We, ourselves, to cite our own policy in this connection, send each stockholder or every security holder of record a detailed monthly statement of earnings of the company, and these statements of earnings are supplemented at various times by other items of interest relating to the company and its subsidiaries. The annual report covers the operations of the company for the

year under review in concise and comprehensive detail, and the features of comparative statements of earnings, condensed balance sheets of the parent company, and combined balance sheets of its subsidiaries give information to the stockholders of the utmost value. While this method apparently is confined to large corporations, in its essentials it applies to practically any corporation. Small corporations, once they decide upon cultivating the good-will of stockholders, find it comparatively easy to pass around to those interested, various items of information having to do with the company's status, its plans for the future, and the degree of progress being made. Though legally, doubtless, much of this information can be, and all too commonly is, kept from stockholders, it should not be if the company's best interests, broadly considered, are kept constantly in view.

Subscription Privileges, or Rights

It appears evident upon a moment's thought that stockholders represent the thrifty element in a community which continues to amass savings and that, if relations with them are properly cultivated, their savings can be expected to flow back towards the corporation in payment for further investments. This does in fact take place.

The placing of new issues in any considerable volume frequently introduces into the financial plan a new element — subscription privileges, or "rights" as they commonly are termed.

The methods employed depend largely upon what the organization desires to accomplish when such rights are issued. When such rights are issued for purposes of distributing surpluses the stock will be issued under such rights below the market price then established on the issued outstanding stock. Should raising new capital not be the object, even secondarily, the directors would be more likely to declare a stock dividend.

When, however, the raising of capital is primarily the object, the directors should specify a subscription price reasonably close to the stock's market price. The decision as to what is reasonably close involves numerous factors — the number and financial

strength of the company and interest in it, condition of the money and stock market, the amount of capital needed, etc. Upon these various points, corporation officials often find themselves rather uncertain; and in consequence they have the issue underwritten. The underwriters assist the company's officials in drawing up the plan under which rights will be issued, and for the commission decided upon at the time, agree to take over the balance, if any, not subscribed for by the stockholders.

Small Company Financing

While the plans described are those employed by the larger corporations, smaller companies can follow these same methods in general, but in a less formal way. The small corporation very commonly was financed at the outset by a few persons, to whom the risks were known fairly well, at least, and in whose hands control has since rested.

The securing of additional funds ought, if possible, to proceed along much the same lines. Additional stock will be offered to the company's present stockholders, in proportion to the holdings of each. Should the funds which can be raised in this way not be ample or should the directors find that, with respect to new security issues, by varying the conditions as to income, risk and control, they can appeal advantageously to outsiders, preferred stock or bonds may be offered to the new, and outside interests. With these small and close corporations, the problem of keeping stockholders informed and interested in the company's activities commonly solves itself. Incidentally, this is one reason why they maintain themselves, and expand, as well as they do.

CHAPTER VI

BUILDING A STRONG BASIS FOR FINANCING

Sources of Funds

Those who direct the financial policies and operations of practically any progressive corporation face the problem dealt with in the preceding chapters — how secure the funds desired for expansion and improvements. These funds can be derived from two sources only, (1) earnings reinvested in the business and (2) money advanced by investors. Wise corporation management utilizes both these sources.

While those in the financial department necessarily concern themselves with the securing of fresh capital, the corporation's management should never tire in their attempt to increase the volume of productivity, reduce costs, and secure sales at a satisfactory price. The detailed methods for accomplishing these things in practice are numberless; and competent managers, from chief operating officials to humblest foremen, quite properly regard the attainment of efficiency with respect to such matters as among their chief duties. While this, in itself, provides earnings in larger volume which can be ploughed back into the business, it convinces prospective investors also that here is a company in which their funds are likely to prove profitable. This conviction on the part of investors cannot fail to gratify a management of the type here under consideration, for what group of aggressive, far-sighted executives sees at any stage of the company's career no further possibilities of expansion and hence no possible use for new capital.

The investor thus represents the real basis for the financing of an established concern. And the measures described in these chapters for dealing with him in a conservative way concerns not alone the individual corporation but make for the good of business as a whole. Viewed in this larger sense, everything done which

will encourage more people to become direct participants in the activities of corporations through ownership of stocks or bonds will very likely hasten the day to which we may look forward when a more unbiased point of view will govern the public discussions of corporations affairs.

Broadening the Investor's Viewpoint

The wage earner cannot easily see that he is directly interested in the welfare of the railroads and the public utility companies. While he fully recognizes the diminished purchasing power of his own dollar, he too often takes a wholly cynical attitude regarding the problem of a street railway company whose increasing costs of operation must be paid with nickels that will buy no more for the corporation than for himself. He understands the facts well enough, but why should he worry about the matter when he is not financially interested in the company and when he knows no one else who is, except the officers of the corporation who he surmises are the paid hirelings of some absentee owner in the far away land of the wealthy.

No shopkeeper would think of offering his store for sale on the basis of its inventory and without consideration of the cost to him in time, money, and genius in creating the enterprise; but unless he is a public utility stockholder, it is not easy to keep his point of view in the same place when discussing the so-called intangible values of an electric light or street railway company. Whatever valuation he may see fit to place upon the going concern value of his own business, too readily becomes over-capitalization, watered stock, and high finance, when the same idea is put into effect by a corporation, none of whose security holders he ever saw or heard of.

These persons, nevertheless, constitute a security market with possibilities; they will gain the correct viewpoint when they *invest*, and they will invest if proper means to induce them to do so are employed.

Financial Advertising

The more usual type of financial advertisement — the formal

announcement of a new issue for instance — is nearly valueless, according to our experience, except as a public notice to professional investors who are actually seeking securities of about the character of the new offering. In any effort to reach men who do not habitually speak the language of investment bankers, an advertisement must say something that a salesman would say.

To the average man, including many who buy securities regularly, the customary advertisement of a syndicate when bringing out an issue, is no more inspiring than an epitaph. Most people would be just about as much interested if you were to substitute the dates of birth and death of someone for the "dated" and "due" in one of these cold financial advertisements; in place of the "authorized issue" state the number of the decedent's original children, and put down the number now living as the "outstanding amount"; name the minister who buried him in place of the lawyers who passed upon the legalities; use all sizes and kinds of type to keep the legibility close to that of a tombstone; state that the body is buried here instead of "recommending the issue as a permanent investment"; and finally, down at the bottom, cross out the safety clause about having obtained the data from reliable sources but not being responsible for its accuracy, and substitute the equally good phrase for advertising purposes, "Rest in peace."

Except for the few investors who are actually students of securities, the average man is more interested in being given some reason why he should like to have the issue mentioned in an advertisement, than in any formidable schedule of facts arrayed by lawyers and statisticians. He wants to know how it will work out in his case. He can be inspired to action by a message which reads like that of one human being to another.

Valuable Service Performed

Selling corporation securities to new investors is not only of direct advantage to all corporations by distributing friends of business all over the land, but a valuable service is performed for the individual in teaching him to become an investor.

There are a great many people, we have observed, who gladly listen to a discussion of investments and who regard the proposition as an opportunity to themselves to learn how to solve the universal problem of getting ahead — call it thrift if you prefer the word — which exists in a greater degree than one might believe until he had examined the facts at first hand.

Consider the case of a family in a certain western city who had seen enough of trouble so that as a means of providing an anchorage for use in some future storm, they were saving twenty dollar gold pieces in a row under the edge of the carpet. There was the instinct of thrift but no understanding of how to take the second step. Another case is that of a motorman and his wife, who, too, was thrifty, and employed as a servant, who paid for their initial purchase of securities in cash and greatly welcomed a method of making investments from time to time as the money came in. They also learned with great interest that instead of trying to collect enough cash to live on in their old age, they might use their savings to buy an income instead, and keep the principal intact. Examples by the hundreds could be found where people were glad to learn the fact that corporations were not alone designed as profiteering juggernauts of high finance, but were instruments for investment whose advantages are available to every one great and small.

The Broadened Investment Market

Of course, one assumes a responsibility in advising people of small means respecting the investment of their savings, for a serious loss might become a calamity. But the recommendation of a well taught or properly advised security salesman of honest intentions is better than no progress at all and none of us should avoid such occasions — rather should we seek them. Every time we teach a man to become a security holder we make a contribution to the public fund of common sense; for beside accomplishing the necessary purpose of raising capital for a growing business, we make in every case a dependable voter who is anti-Bolshevik and immune to its buncombe. Furthermore, the new

Regular Monthly Income of $25

Free from Normal Federal Income Taxes

may be secured for about $3,600

by the purchase of

50 Shares
6% Cumulative
Preferred Stock

CITIES SERVICE COMPANY

Circular P upon request

Henry L. Doherty & Company

60 Wall Street
New York City

An Effective Piece of Newspaper and Magazine Copy

This offering of a permanent monthly income at a definite and reasonable price has produced inquiries in large numbers, many of which were turned into sales by correspondence or personal interview. Its pulling power seems but little influenced by market conditions or by seasons.

EDITOR'S NOTE: *Clients will appreciate that the above is inserted simply as an example of effective advertising copy, without reference to the security itself.*

convert is sure to be an attorney of the public welfare among all his friends.

The Liberty Loan campaigns have induced millions of new people to become owners of income-producing securities, and clipping coupons is an inspiring business to anyone, whether rich or not. The new discovery that one may buy an income just as one buys anything else, we all firmlv believe, will add a great impetus to the distribution of corporation securities. It may appear like an effort to capitalize a calamity to point out that, in their experience with Liberty Bonds, these millions of people have observed something else that every security holder has to learn; namely that the market value is not a constant quantity. Thus we are relieved of the difficult task of explaining to a new investor why a certain stock or bond may not command the same price any day and any minute.

All these millions of new people have learned three of the fundamental lessons of investing in securities: That they can find the money to invest if they have the will to do it; that it is a comfort to cash a coupon and receive income which can be spent while the principal remains still intact; and that fluctuations may occur in market quotations. In developing new buyers of corporation securities now, one may proceed in much the same way as though dealing with people who already were security holders. The opportunity to spread out sales to an astonishingly large number of people is practically made to order. The beauty of the situation lies in the fact that as corporation officials vigorously pressing our own business we are at the same time performing a public service.

TEST QUESTIONS

"SECURING CAPITAL FOR AN ESTABLISHED ENTERPRISE"

The Test Questions which are unstarred can be answered directly from the Text discussion. You will find them helpful for purposes of review.

The Questions which are starred call for original thought, the ability to apply the knowledge gained from the Text to the solution of new problems.

ANSWERS TO STARRED QUESTIONS ARE APPENDED

1. What general factors must be studied when money is to be raised by a corporation?

*2. In what period of the business cycle, given good earning power, is new financing accomplished most satisfactorily?

3. Why is a budget essential in estimating capital requirements?

4. How are syndicate profits determined?

5. What are the two most widely used underwriting agreements?

*6. If you were running a shoe factory, earning 10% on the common stock of $5,000,000 after providing for interest on $5,000,000 6% bonds outstanding callable at 105, and wanted to build a box factory which you thought would earn $750,000 annually, which you could get for $3,000,000, how would you go about raising the money? What would you consider offering bankers?

7. What do you think of selling securities direct to employees and customers? What are the good points? What are the drawbacks?

8. If you believed in the above, how would you go about it? As regards price compared with outstanding issues? As regards payment?

9. In what ways can the good-will of stockholders be gained?

*10. Read Chapter IV carefully. There is a lot in it. What was the apparent method behind Cities Service's financing? Its capitalization has grown from about $26,000,000 preferred and $20,000,000 common to $70,000,000 preferred, $40,000,000 notes, and $33,000,000 common. What has been the position of common stockholders during this period?

ANSWERS TO STARRED QUESTIONS

"SECURING CAPITAL FOR AN ESTABLISHED ENTERPRISE"

*2. The question presumes good earning power. The problem then becomes one of financial conditions. The best period for financing is that immediately following a renewal of prosperity. Our textbook, "Business Cycles," outlines the different phases and changes. In a period of depression, while money is cheap, financing is not easy, because buyers are scarce. In the early stages of prosperity, confidence is restored, but money rates do not advance perceptibly.

In the late stages of prosperity while business is booming, the abnormal demands have advanced interest rates. The period immediately following renewed prosperity is, therefore, the most satisfactory.

*6. The interest on $5,000,000 6's would be $300,000 a year. Ten per cent on $5,000,000 is $500,000. Hence, present net earnings are at least $800,000 a year. Counting new factory, earnings would be $1,750,000. The thing to do then would be to combine, giving the new property the good-will of the old. Retire your $5,000,000 bonds at 105. Issue $8,000,000 new bonds covering all property. Charges at 6% would be $480,000. Old property alone would cover them two times over. Hence, total issue should sell easily.

*10. The common stockholders of the Cities Service Company, by lending the benefit of the credit of its old-established properties to its new, were able by issuing 7% debentures and 6% preferred, to obtain money relatively cheap on which it was possible to earn large sums. They naturally benefited tremendously. The earnings of the old properties afforded note and preferred stockholders' dividends. A good illustration of using the established credit, where the outlook is reasonably certain, to enter new and highly profitable fields at a low cost.

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